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AGENDA ITEM 7a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** International Fixed Income Managers Annual Review
- II. PROGRAM:** External International Fixed Income
- III. RECOMMENDATION:** Renew the contracts for all CalPERS' external international fixed income managers for a period of one year. Wilshire Associates' opinion letter is shown in Attachment 1. Wilshire Associates' disclosure letter is shown in Attachment 2. The five managers are:

Baring Asset Management
Julius Baer Investments Limited
Bridgewater Associates
Rogge Global Partners
Western Asset Management

IV. ANALYSIS:

Background

CalPERS implemented the international fixed income program in May 1989, to provide diversification and achieve efficient frontier objectives in the CalPERS investment portfolio. The assets under management as of August 31, 2005 were approximately \$5.62 billion.

The international fixed income program currently consists of five managers, all of whom were hired in August 2000, and were funded as of September 2000 under one-year annual review contracts. Of these managers, two had existing contracts with CalPERS. Baring has been with CalPERS since October 1989, and Julius Baer since April 1994. The remaining three managers were new hires in August 2000. A sixth manager, Wellington Asset Management resigned in February 2005.

Recommendation

Staff and Wilshire are recommending renewal of the contracts of Baring Asset Management, Julius Baer Investments Ltd., Bridgewater Associates, Rogge Global Partners and Western Asset Management for a period of one year. Each contract contains a provision allowing for termination by either party with 30 days notice.

Market Environment

The period in review supports the role of investment portfolio diversification. The twelve month period ending August 31, 2005 was characterized by an uneven global economic expansion, punctuated by periods of market volatility related to high energy prices, higher short term interest rates and political uncertainty.

The U.S. economy continued to attract close attention as reasonably strong economic growth ensured a tighter monetary policy stance by the Federal Reserve. In the closing months of 2004, world economic growth was positive while inflation remained contained. Under this benign scenario, markets focused on event risks including uncertainty surrounding the U.S. election and the ever growing current account deficit. Subsequently, the downtrend in the U.S. dollar accelerated and non-U.S. dollar bonds performed well.

Through the first quarter of 2005, global economic data turned softer and the U.S. dollar reversed course. At approximately the same time, reforms to the European Stability and Growth Pact and the rejection of the EU Constitution by French and Dutch voters further undermined support for the Euro. Globally, non-U.S. bonds continued to rally spurred by muted inflation and slower growth.

Market sentiment in the summer months was very temperamental. Economic data confirmed that the "soft patch" in activity was ending, leading to declines in international bond markets. The surprising news from a timing standpoint was China's removal of its currency peg versus the USD, and to shift to a managed basket. The market interpreted this change as being more politically than economically meaningful. The move was able to diffuse some of the political tension that had been growing between China and the U.S.

Table 1 on the following page shows returns of various international bond markets during the review period.

Table 1

Bond Market	Annual price return year ending August 31, 2005
U.S. Treasury - 10 yr	+0.6%
Japanese Government Bond - 10 yr	+2.7%
Deutschland Republic - 10 yr	+7.7%
UK Treasury – 10 yr	+5.6%

Source: Bloomberg and CalPERS

Currency Effect

The U.S. dollar had a mixed performance against developed market currencies during the period August 2004 to August 2005. The Euro was marginally stronger vs. the dollar, ending at 1.2346, up from 1.2183. A similar story was seen with the British Pound. Sterling ended the period slightly higher at 1.8041, up from 1.8024. The Japanese Yen ended the period weaker at 110.60 after a start at 109.17. These seemingly minor moves from point to point mask significant intra-period volatility. At the end of calendar year 2004, major currencies ended at multi-year highs versus the U.S. dollar. Throughout the remainder of the review period, the dollar was able to rally strongly, by approximately 8%, to end near to where it had begun the period.

Overall Program Performance

The international fixed income program benefited in this economic backdrop as the managers were tactically able to capitalize on periods of declining yields.

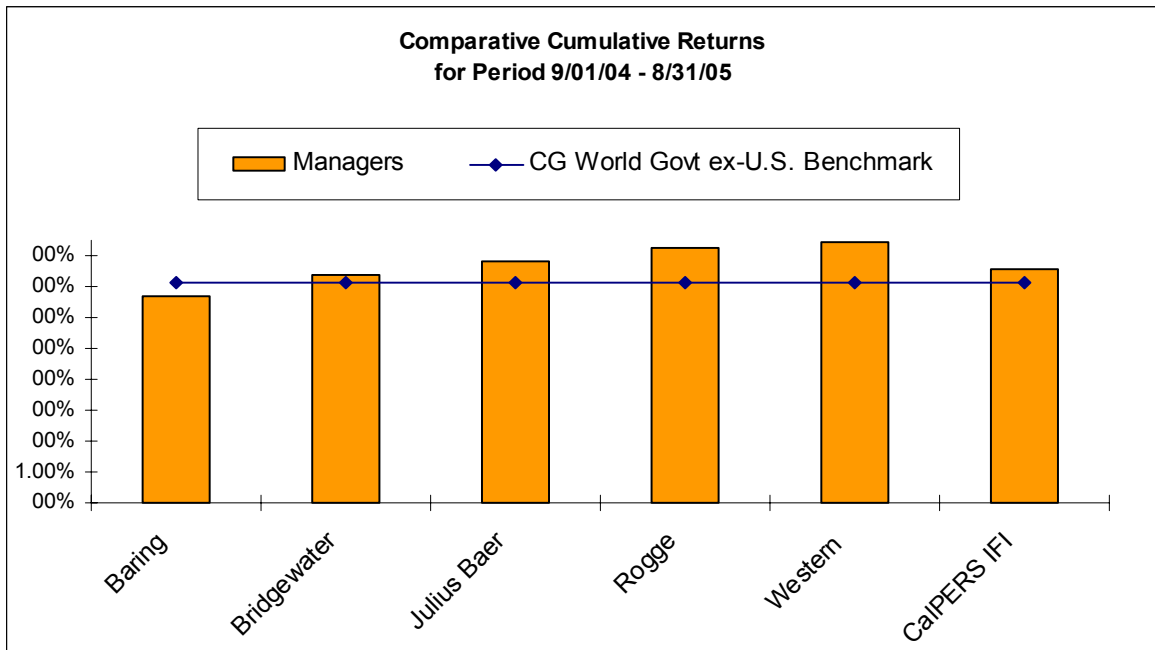
For the one-year period ending August 31, 2005, the benchmark for the CalPERS international fixed income program (Lehman International Fixed Income Index, LIFII) posted a positive return of 7.11%, while the program as a whole returned 7.55%, an outperformance of 0.44%. Table 2 below shows the individual manager performance for the review period.

Table 2

Active Managers	Portfolio Performance Sept 04 – Aug 05	Benchmark Performanc e	Excess Return
Baring Asset Management	6.71%	7.11%	-0.40%
Julius Baer Investments Ltd.	7.79%	7.11%	+0.68%
Bridgewater Associates	7.36%	7.11%	+0.25%
Rogge Global Partners	8.25%	7.11%	+1.14%
Western Asset Management	8.46%	7.11%	+1.35%
Total	7.55%	7.11%	0.44%

On the following page, Figure 1 compares the returns of the individual managers and the program as a whole to the benchmark over this one-year period.

Figure 1



Assets Under Management

As of August 31, 2005, total assets under management for the CalPERS international fixed income program were approximately \$5.62 billion. Table 3 shows the corresponding assets managed by each manager.

Table 3

Manager	Portfolio Value (in millions)	Percent of Portfolio
Baring Asset Management	\$998.3	17.76%
Julius Baer Investments Ltd	\$1,144.7	20.36%
Bridgewater Associates	\$1,274.4	22.67%
Rogge Global Partners	\$1,280.9	22.78%
Western Asset Management	\$923.7	16.43%
Total	\$5,622.00	

Program Performance

The strategic objective of CalPERS international fixed income program is to provide diversification and enhance the CalPERS investment portfolio with respect to efficient frontier objectives. The objective of the external managers is to outperform the Lehman International Fixed Income Index, net of all management fees.

Over the trailing twelve-month period ending August 31, 2005, the Program outperformed its benchmark by 0.44%. The program has also outperformed its benchmark since the most recent funding date (September 1, 2000 through August 31, 2005) by 0.26% on an annualized basis. On a cumulative basis, the Program has added 1.86% over its benchmark over the same period. Since the program inception in October 1989 the program has outperformed the benchmark by 1.00% annualized and by 55.28% cumulatively. Figure 2 illustrates the annual and cumulative performance of the Program since the inception date.

Figure 2

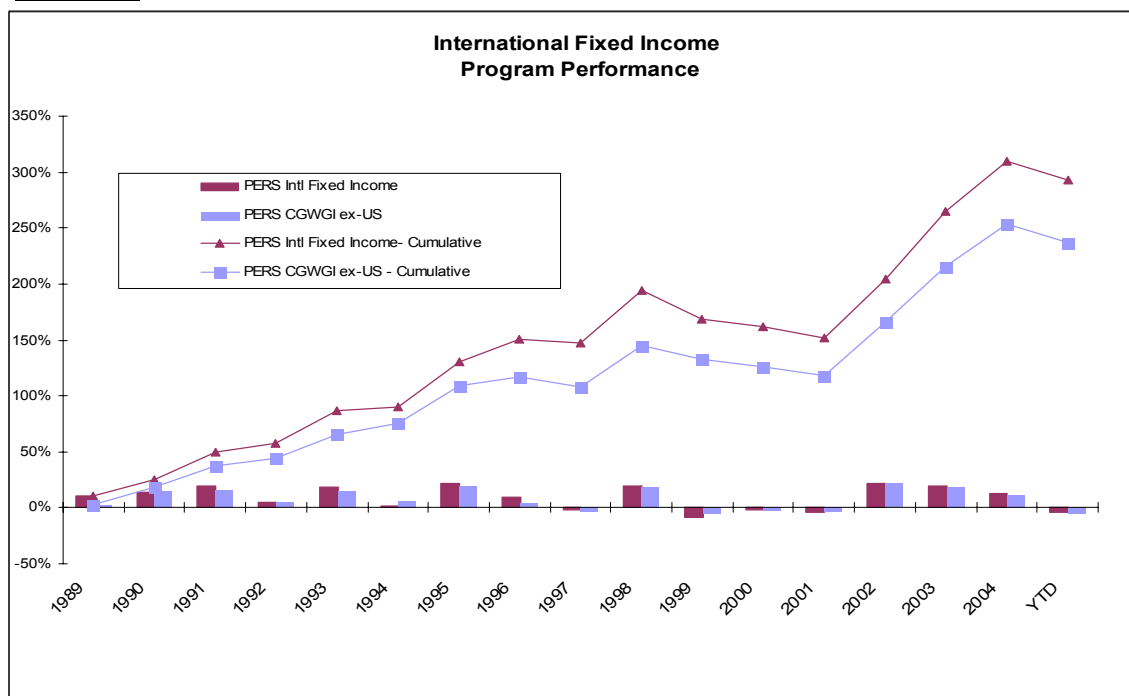


Table 4 below illustrates each manager's annualized performance relative to its custom benchmark since the most recent funding in September 2000.

Table 4

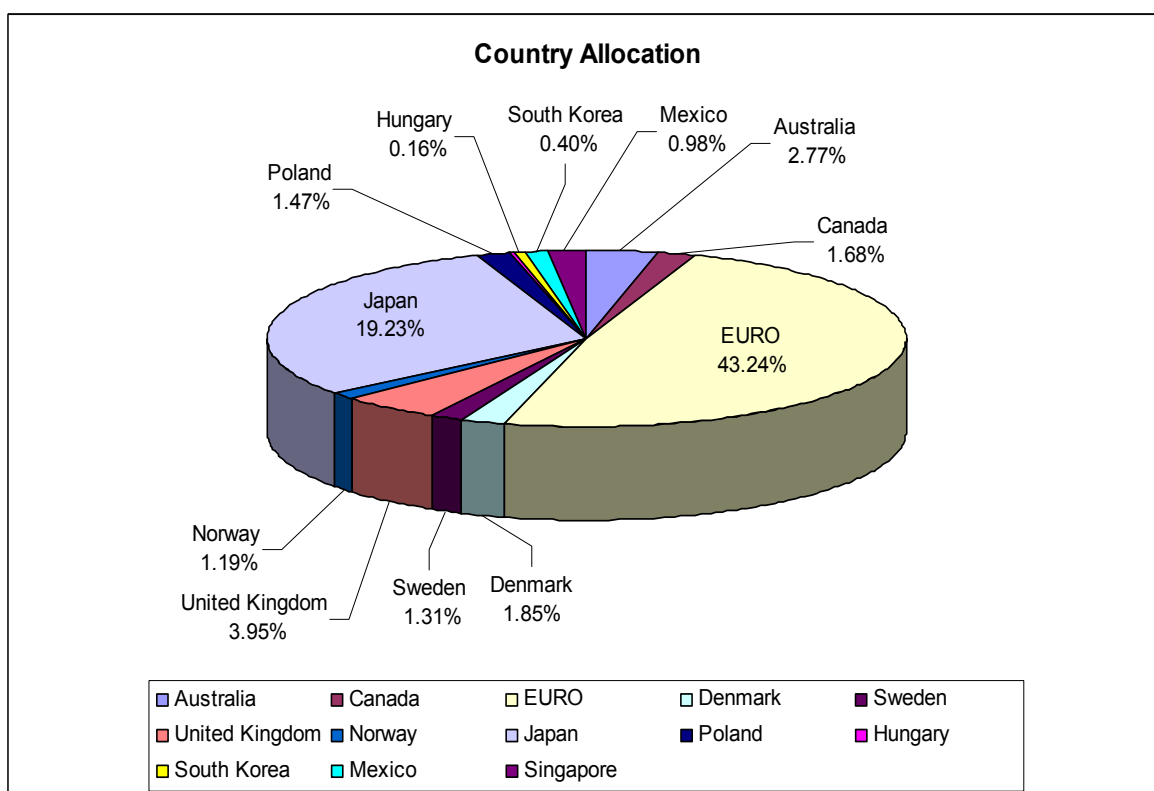
Active Managers	Portfolio Performance Since Sept 2000	Benchmark Performance Since Sept 2000	Excess Return Since Sept 2000
Baring Asset Management	9.25%	9.07%	0.18%
Julius Baer Investments Ltd.	9.25%	9.07%	0.18%
Bridgewater Associates	9.52%	9.07%	0.45%
Rogge Global Partners	9.31%	9.07%	0.24%
Western Asset Management	9.37%	9.07%	0.30%
Total	9.33%	9.07%	0.26%

Over the past year, four of the five managers outperformed the benchmark and one underperformed. The differences in returns can be attributed to investment style and sector focus, which was an objective in structuring the program.

Country Exposures

The aggregate country exposure of CalPERS international fixed income program as of August 31, 2005 is shown in Figure 3. This chart separates the bond holdings by country, demonstrating the diversification being provided by the managers through a number of liquid foreign bond markets.

Figure 3



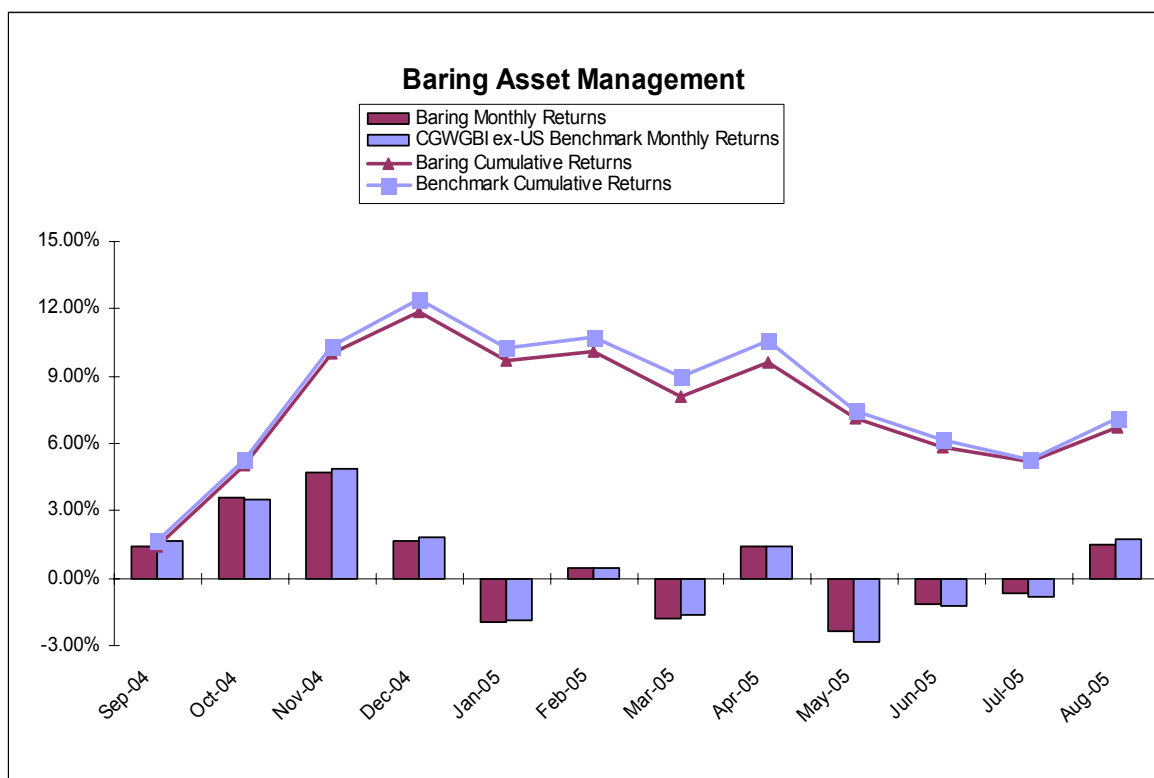
Individual Managers Performance and Evaluation

Baring Asset Management

Baring's investment philosophy is fundamental in nature, based on the belief that superior performance can be generated by understanding what markets have already discounted and where the consensus is positioned. Through their four-step portfolio construction process and multiple scenario analysis, Baring's objective is to add value through sovereign, corporate, and currency strategies while reducing return volatility.

Since inception in October 1989, the portfolio has returned 9.55% annualized, compared to 7.92% for the benchmark, an outperformance of 1.63%. For the twelve-month contract period ending August 31, 2005, the portfolio returned 6.71% compared to 7.11% for the benchmark. Most of Baring's underperformance of 0.40% can be attributed to currency selection and duration decisions. The monthly breakdown of this period is shown in Figure 4 below. As of August 31, 2005, Baring had \$998.3 million in assets under management.

Figure 4



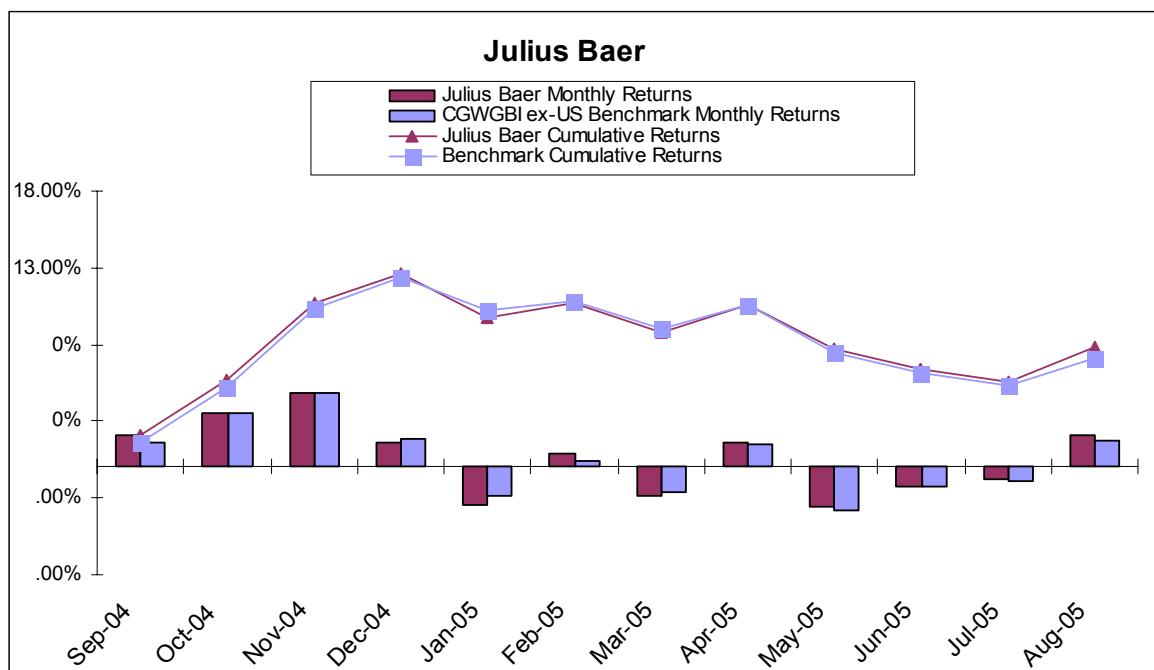
Julius Baer Investments Limited

Julius Baer Investments Limited believes in a disciplined approach to the active management of currency weightings, yield curve positioning and bond/cash percentages. The investment process includes the development of investment strategy and tactics. Investment strategy is based on forecasts of interest rate and currency returns over 3, 6, and 12 months and is designed to take advantage of major currency and bond movements over a like time horizon. Julius Baer's fundamental focus is on identifying bond markets with high prospective returns adjusted for inflation. Tactical changes involve yield curve and currency changes and are reviewed on a weekly basis.

In circumstances where Julius Baer favors a bond market but does not favor the currency, it uses the forward exchange market to effect rapid and efficient changes in currency weightings at the least cost. Hedging is typically used when Julius Baer feels positive about a country's interest rates, but is not attracted to the currency or vice-versa. Hedging is used both to protect the portfolio, and to add value in the short-term.

Since inception in April 1994, Julius Baer has returned 7.29% compared to 6.26% for the benchmark for an outperformance of 1.03%. For the twelve-month contract period ending August 31, 2005, the portfolio returned 7.79% compared to 7.11% for the benchmark. Julius Baer's outperformance of 0.68% can largely be attributed to country and currency selection. The monthly breakdown of the period under review is shown in Figure 5 below. As of August 31, 2005, Julius Baer had \$1,144.7 million in assets under management.

Figure 5



Bridgewater Associates

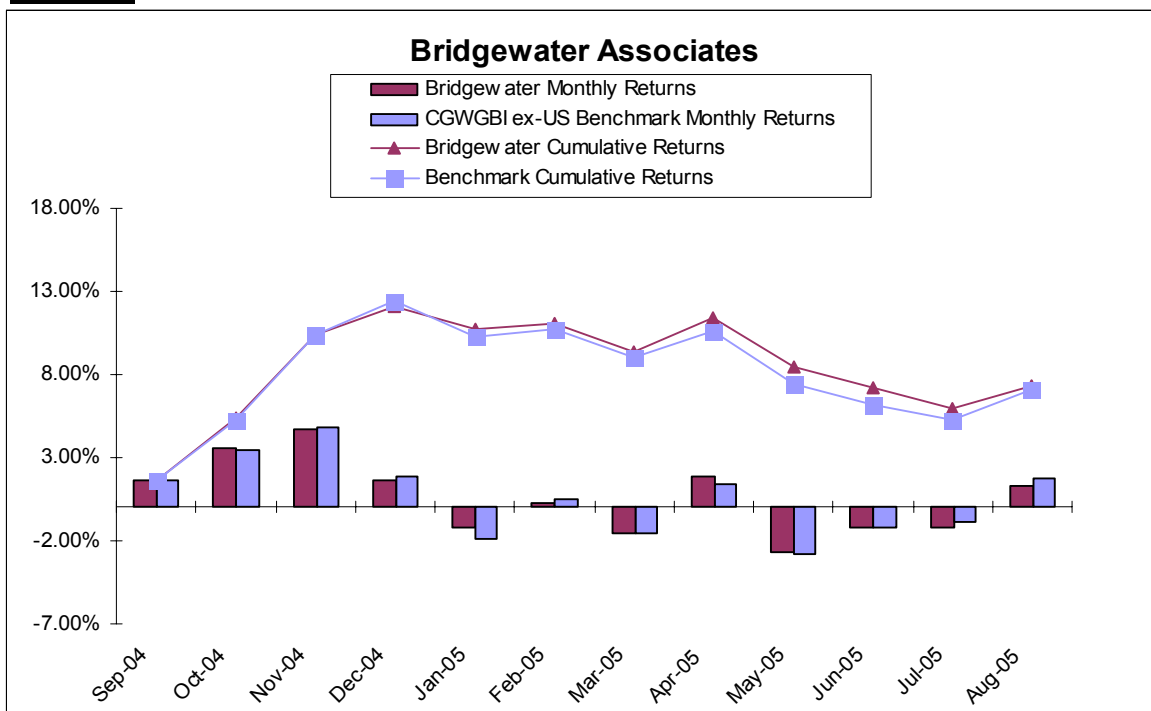
Bridgewater believes in fundamental analysis and applies their belief on a completely systematic basis. The criteria used to evaluate markets are very explicitly defined. Before a criterion is incorporated into the decision making process it is stress tested through time and across countries, then debated internally. Only through conviction at all levels is the decision making criteria then programmed into the computer. The reliance on their systematic approach is what defines the Bridgewater investment strategy.

A two-step process is utilized in managing a portfolio. First, an index portfolio replication of the benchmark is built to match the exposures and return of the benchmark. Then, based on its systematic assessment of market pressures, the manager selectively deviates from that benchmark to add value. Value added is created by making the selections between various sectors, countries and between individual bond issues. Currency hedging is used both to protect the portfolio, and to add value in the short-term.

Since inception on September 1, 2000, Bridgewater has returned 9.52% annualized compared to 9.07% for the benchmark, an outperformance of 0.45%. For the twelve-month contract period ending August 31, 2005, the portfolio returned 7.36% compared to 7.11% for the benchmark. Most of the outperformance of 0.25% can be attributed to the firm's correct interpretation of fundamental factors driving global bond and currency markets.

The monthly breakdown of this period is shown in Figure 6 below. Assets under management as of August 31, 2005 were \$1,274.4 million.

Figure 6



Rogge Global Partners

Rogge utilizes a fundamental approach based on the analysis of longer-term financial and economic trends, and their implications for the interactions between interest rates and exchange rates. Active in country/currency allocation decisions, Rogge pays particular attention to total debt, savings rates and

monetary growth, as well as the credibility of monetary authorities in determining the relative health of a given country.

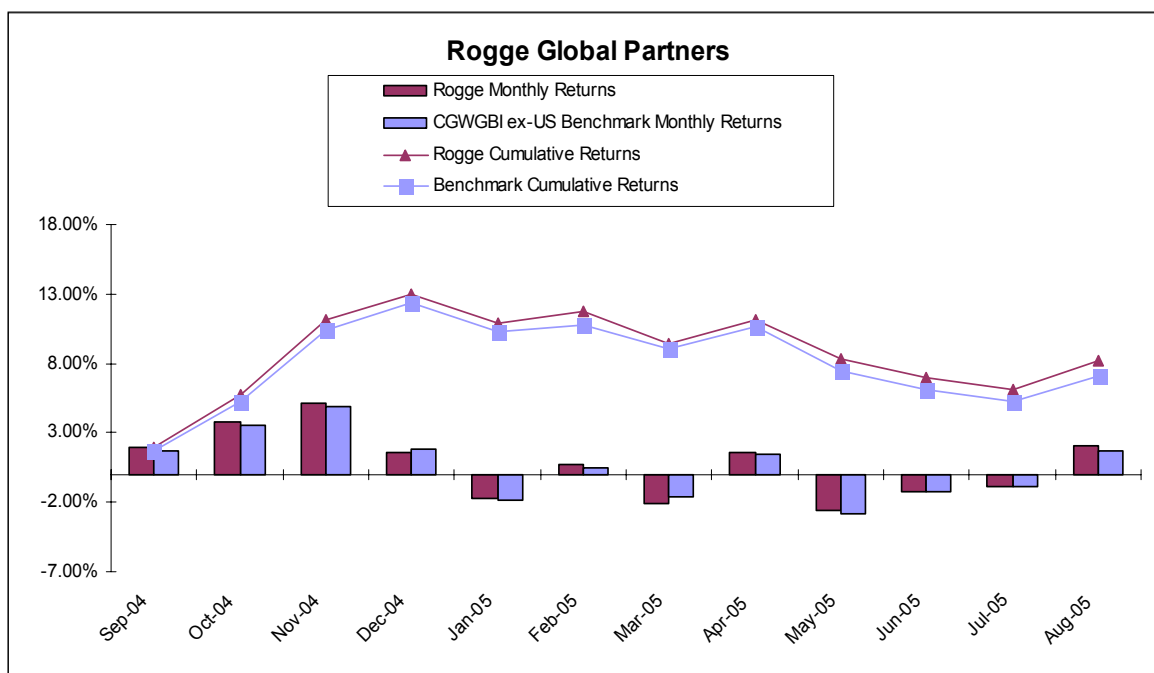
Rogge has a four step process: 1) Relative Value Analysis, 2) Portfolio Modeling, 3) Micro Level Analysis and 4) Implementation. The primary source of Rogge's alpha is country & currency selection, although duration and to a lesser extent, sector and security selection also add value.

Rogge's allocation tends to be heavily concentrated in a relatively small number of markets that are expected to outperform the index. The risk of these positions is closely controlled via the tracking error defined in their mean-variance model. Rogge also determines a proposed credit allocation for a given tracking error.

Rogge was funded by CalPERS on September 1, 2000. Since their inception, Rogge had a return of 9.31% compared to 9.07% for the benchmark, an outperformance of 0.24%. Over the twelve month review period, Rogge had a return of 8.25% compared to the benchmark return of 7.11%. The outperformance of 1.14% was due to currency selection and an overweight of corporate credit.

The monthly breakdown of this period is shown in the Figure 7 below. Assets under management as of August 31, 2005 were \$1,280.9 million.

Figure 7



Western Asset Management Company

Western Asset Management (Western) has a philosophy of exceeding benchmark returns while approximating benchmark risk. This is based on the belief of inefficiencies existing in the fixed income markets and incremental value

can be added by exploiting these inefficiencies. This approach combines traditional analysis with innovative technology applied to all market sectors.

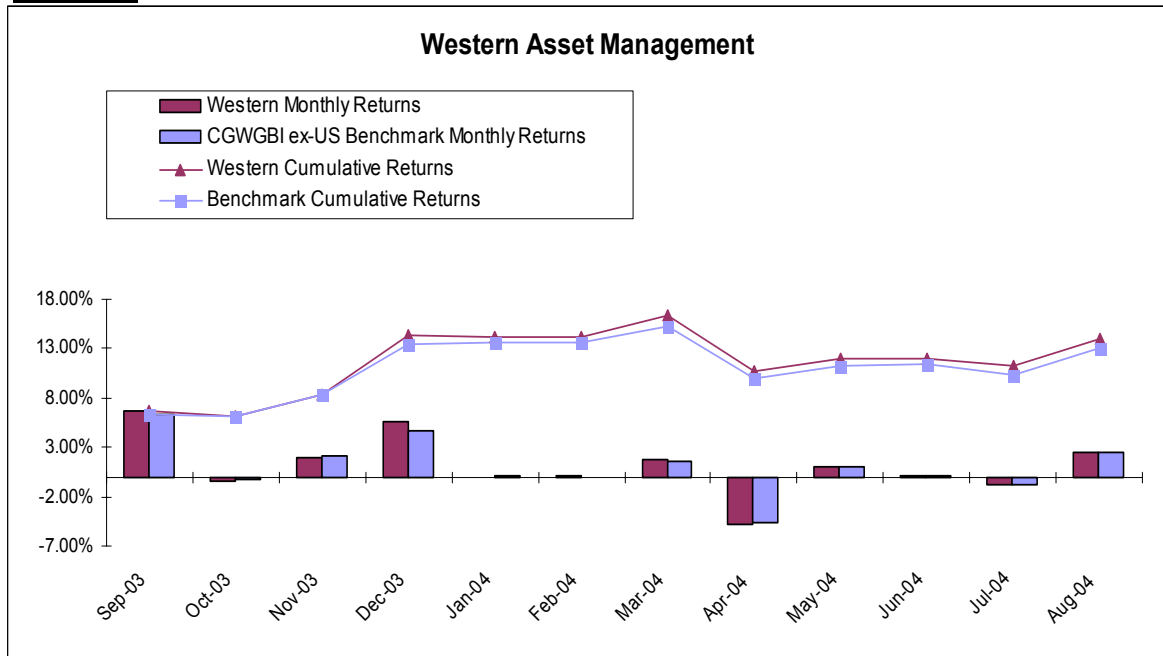
The firm uses internal and external data to develop an investment outlook for each market, focusing on analysis of macro and micro data and conditions. To minimize the variability of investment returns relative to the benchmark, weighted average duration of each portfolio is constrained to a range of + or - 20% of the benchmark duration. Focus is over the next 3-6 months with a balance across strategic decisions such as duration weighting and term structure positioning; country/currency allocation; sector allocation; and issue selection.

Western believes that rotating among and within countries and currencies can enhance returns. While adjustments to country and currency weightings can add value currency exposures would in general be tactical and modest in nature due to the volatility component and effect tracking error.

Since inception on September 1, 2000, Western had a return of 9.37% compared to 9.07% for the benchmark, an outperformance of 0.30%. Over this one-year contract period, Western had a return of 8.46% compared to 7.11% for the benchmark. The majority of the portfolio's alpha of 1.35% was generated by currency selection and by an overweight in corporate credit that during this period positively impacted returns versus the benchmark.

The monthly breakdown of the period under review is shown in Figure 8 on the following page. As of August 31, 2005, Western had \$923.7 million in assets under management.

Figure 8



V. STRATEGIC PLAN:

External investment manager performance is monitored by staff and reported to the Investment Committee per CalPERS Strategic Plan, Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX: Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The purpose of this item is to keep the Investment Committee informed of staff's efforts to ensure that the international fixed income external manager program is performing in line with expectations. All results shown are net of management fees.

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